HOW MULTINATIONAL COMPANIES (MNCs) FINANCE THEIR OPERATIONS IN CHINA

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ABSTRACT

Since China started its economic reform in 1978, its GDP has been growing at an average rate of more than 9 percent per year. Foreign direct investment is the engine of growth in recent years and foreign-invested enterprises have become a critical component of the economy. In recent years, greater versatility was seen in China's FDI with investments from the OECD countries. Most of these investors are multinational companies setting up their presence in China. Today, more than 400 of the top 500 MNCs have invested in China.

Despite the impressive growth and significant economic influence of MNCs, financing options available to these foreign companies in China are surprisingly limited. Like other developing countries, the financial market in China is still largely banking-dominated. The domestic equity and bond markets are poorly developed. As most MNCs in China are still at their developing stage, their financing requirement is huge. Currently, this requirement is mainly supported by foreign banks operating in China and to a lesser extent by domestic banks. Lending by foreign banks is usually based on the strength of the parent MNC while lending by domestic banks is always required to be fully secured.

Meanwhile, MNCs operating in China still have many unfulfilled financing needs. It is anticipated that future changes in China's financial markets brought about by the WTO entry and the domestic banking reform will increase MNCs' financing availability and options. Waiting these to become realized, MNCs are recommended to move ahead now to maximize current financing available and get prepared to reap opportunities in the near future.

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SOURCES OF FDI, 1979-96 & 1997

Country	1979-96	1997
Hong Kong/Macau	57.2%	46.4%
Taiwan	8.7%	7.3%
OECD Countries [a]	22.0%	29.3%
Others	12.1%	17.0%

Data Source: MOFTEC

[a] Including US, Japan, UK, Germany, Canada, Australia, South Korea

TABLE 2

% SHARE OF UTILISED FDI BY INVESTMENT STRUCTURE, 1992-1Q 1999

	1992	1993	1994	1995	1996	1997	1998	1Q 99
Equity JV	55.6	55.8	53.1	50.8	49.7	43.2	41.3	37.6
Cooperative JV	19.3	19.0	21.1	20.1	19.4	19.7	20.5	18.9
WFOE	22.9	23.6	23.8	27.5	30.2	35.7	36.2	42.3
Others	2.2	1.6	2.0	1.6	0.7	1.4	2.0	1.2

Source: MOFTEC

TABLE 3

MAJOR DOMESTIC BANKS, END-1997

	Incorporation	Network	Employees	Total assets
				(US$ billion)
ABC	1979	63,676	536,816	190
BoC	1905	15,251	200,135	306
CCB	1954	32,787	382,932	203
ICBC	1984	41,990	561,279	489
BoCom	1908	2,788	47,072	54
CITIC Industrial	1987	131	4,000	15
Pudong Development	1992	136	2,260	10
China Everbright	1992	13	1,560	7
Hua Xia	1993	19	1,500	5

Source: Banks' annual reports

TABLE 4

MAJOR FOREIGN BANKS IN CHINA, MID-1998

Bank	Home Country	No. of Branches	No. of Rep. Offices
Standard Chartered Bank	UK	8	3
Hongkong and Shanghai Banking Corp.	UK	8	2
Bank of East Asia	HK	6	6
Societie Generale	France	5	1
Bank of Tokyo-Mitsubishi	Japan	4	2
Banque Nationale de Paris	France	4	2
Dai-Ichi Kangyo Bank	Japan	4	2
OCBC	Singapore	4	2
Citibank	USA	4	1
Industrial Bank of Japan	Japan	3	2

Source: The Economist Intelligence Unit

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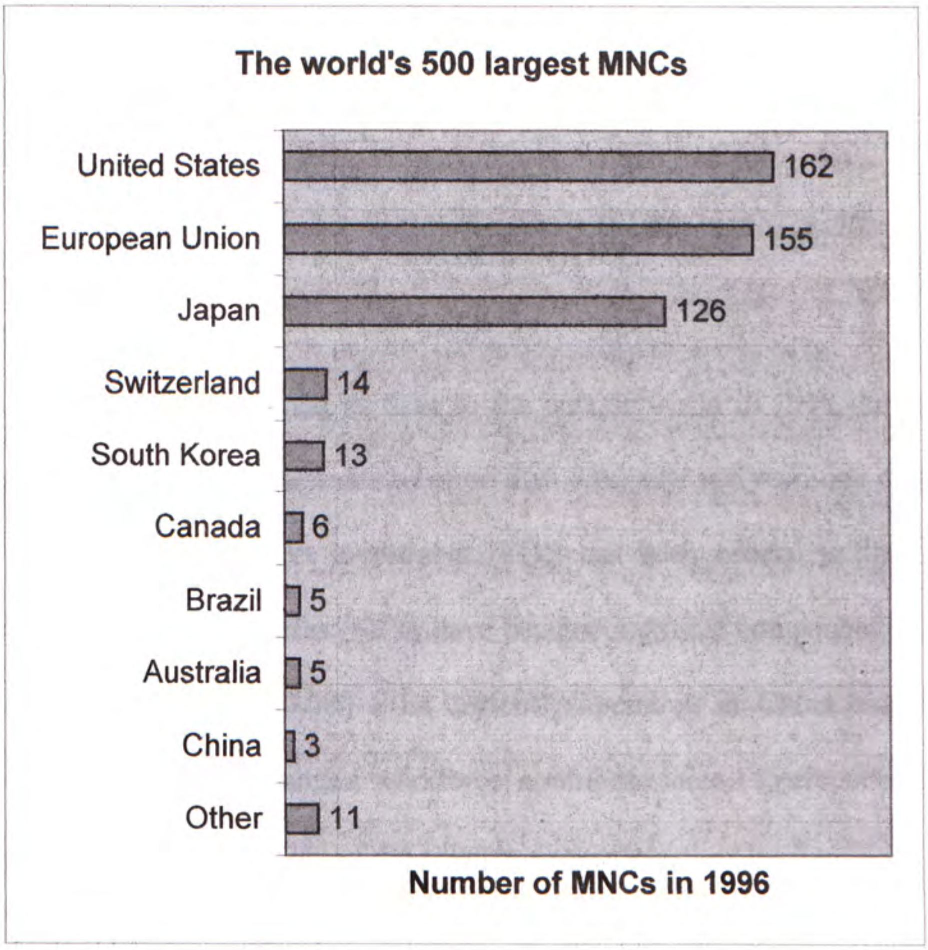

Source: "The Fortune Global 500." Fortune. 4 August 1997.

CHAPTER I

INTRODUCTION

Since China opened its door to the outside world in 1978, its real GDP has been growing at an average rate of more than 9 percent per year, one of the fastest in the world. Foreign direct investment (FDI) has been crucial to this growth and foreign-invested enterprises (FIEs) have become a critical component of the Chinese economy. The over 140,000 FIEs currently operating in China employ about 11 percent of the non-agricultural workforce, contribute some 14 percent of the industrial output and share about 41% of the country's exports[1].

Traditionally, Hong Kong used to provide more than half of China's incoming FDI. However, the regional downturn in the past two years has increased the prominence of investors from the OECD countries. Table 1 shows sources of FDI in China in the period 1979-96 and in 1997. Investors from Europe, United States and some developed countries in the Asia-Pacific area have increased drastically and most of these investors are multinational companies (MNCs) setting up their presence in China. Today, more than 400 of the top 500 MNCs, and 59 of the 100 largest MNCs have established presence in China[2].

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[1] According China Construction Bank's Publication.

[2] "CCB to strengthen cooperation with multinational corporations." People's Daily, 8 November 1999.

Despite the impressive growth and significant economic influence of FIEs, in particular MNCs, financing options available to these foreign-invested companies in China are surprisingly limited. Both the equity and bond markets in China are still at their infant state. Commercial banks are still supplying the lion's share of MNCs' financing requirements.

Objectives Of The Study

The purpose of this study is to examine the financing needs of MNCs in China, how they are currently financed and how financial markets would change to meet their needs. Specifically,

- Chapter II gives an overview of MNCs in China and Chapter III examines their financing needs.
- Chapter IV looks in detail into how MNCs currently finance their operations in China. A case study is conducted to illustrate as well.
- Chapter V summarizes the restraints of the financial markets on one hand and Chapter VI discusses the anticipated future changes of the financial markets in meeting MNCs' financing needs on the other. A few recommendations are suggested to MNCs in response to such changes.

Methodology Of The Study

The study focuses on information and facts through which a picture on how MNCs currently finance their operations in China is presented. Sources of information and facts are gathered through a combination of the following: -

- A wide range of literature research and official statistics;
- Discussions with both Chinese and foreign banks which are operating in China and banking with MNCs operating in China;
- Informal discussions with some MNCs operating in China; and
- The past six years of actual working experience of the author in both Chinese and international banks.

CHAPTER II

MNCs IN CHINA

Advances in technology have intensified the concentration of economic power in the hands of MNCs. Estimates suggest that the largest 500 MNCs conduct well over 80 percent of the world's stock of FDI and over half of its trade[3]. More than 80 percent of the world's 500 MNCs are based in the 'triad' economies of the US, Europe and Japan (Chart 1).

Leading MNCs In China

Since China started its economic reform, FDI has grown from almost zero in 1979 to over US$20 billion for the first 10-year period. During this initial 10-year period, foreign funds came mainly from overseas Chinese including Hong Kong and Taiwan. In the second 10-year period, greater versatility was seen with investments from the OECD countries, with total amount of FDI during the second 10-year period increased phenomenally to over US$230 billion.

Of the OECD countries investing in China, the United States, Germany and Japan stand out as the most active. US firms, including General Motors, Motorola, Coca-Cola, AT&T, IBM, Microsoft, and Procter & Gamble, have invested heavily in

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[3] According to MOFTEC statistics.

China. German firms such as Siemens and Henkel hold dominant positions in consumer and industrial markets while Volkswagen captures over half of China's taxi fleet market. Japanese firms, such as Honda, Matsushita, Sharp, and Sony are among the leading foreign investors in China.

MNCs' Investments In China

While most MNCs entered China in the late 1980s or 1990s, a few early movers entered in the 1970s or early 1980s. The early movers enjoyed more incentives such as greater flexibility regarding investment requirements and market access. For instance, as the Chinese government carefully controlled the pace at which different sectors were opened to foreign investors, early movers had an opportunity to gain a foothold in the Chinese market that was subsequently closed to later entrants.

Contrary to Hong Kong and Taiwan firms, two of China's largest investors, which usually engage in simple processing and assembly production, MNCs dominate international production in major industries such as automobiles, consumer electronics, chemicals, pharmaceuticals and petroleum. Therefore, MNCs often bring advanced technology to China. With their increasing participation in China, more foreign investments have gone into more sophisticated industries. Examples include General Motors's auto-plant joint venture in Shanghai and Royal Dutch/Shell's integrated petrochemical plant in Guangdong, among others. The reform and privatization of the state-owned enterprises (SOEs) in China will further widen the scope of investments by MNCs. Kodak's purchase of the bankrupt state-owned photo film makers in 1998 may serve as a precedent to open up a sector previously barred to foreign investors.

Despite the widening scope of MNCs' investments in China, more recently, many MNCs are concentrating on consolidating and rationalizing their existing investments – through buying out joint venture partners, abandoning unprofitable operations and creating holding companies to streamline dozens of independent operations – rather than rushing to expand into new projects.

Different Entry Modes & Impact Upon Financing

The Trend Of Entry Mode To China

MNCs usually enter China in three major modes and their relative importance changes over time. Equity joint venture is the most common form of market entry, accounting for more than half of the operations in the last 2 decades. Wholly foreign-owned enterprise (WFOE) is the next most common form, followed by cooperative joint venture.

However, more and more evidence suggests that MNCs are increasingly ruling out joint venture (JV) and favoring wholly foreign-owned operations in China. The trend of favoring WFOE to JV can be observed from Table 2. In 1997, WFOEs for the first time outnumbered equity JVs in new project approvals, accounting for 46% of approved projects[4]. Some are new establishments while others represent foreign investors' buying out of Chinese partners, thereby converting JVs to WFOEs.

Another trend we can observe is the formation of holding companies by MNCs. The choice of different entry modes has great impact upon MNCs' financing and this will be discussed in the following section as well.

Joint Venture (JV)

Until recently, the majority of foreign-invested projects in China were structured as equity JVs. These were usually 50:50 ventures in the past as the Chinese government was reluctant to allow foreign investors to hold majority interest. Also, such ventures may be advantageous if they allow for quicker market entry, access, and support from the Chinese government. However since the mid 1990s, foreign investors have been allowed to increase their stake in JVs to majority, giving them control of the boardroom and speeding up decision-making. Foreign ownership of 60-70% then became commonplace.

Cooperative JV is relatively less common. Yet it is perceived to be a more flexible investment vehicle. Under such a JV structure, it is theoretically possible to negotiate into any terms as long as they comply with the Chinese law and are acceptable to the JV parties.

[4] According to MOFTEC statistics.

In areas bearing upon financing, both equity and cooperative JV are considerably more rigid. Equity JV's features include regulated debt-equity ratios and non-negotiable share holdings which are based on the concept of "registered capital" that is quite different from the western "share capital" concept. In addition, JV's ability to establish and invest in subsidiaries is subject to Chinese government approval.

Wholly Foreign-Owned Enterprise (WFOE)

WFOE offers MNCs tight control and exclusive autonomy in operation and management with less Chinese government interference. Besides, it allows MNCs to utilize their most proprietary technologies in the host country market. As such, it is deemed superior to JV structure and is gaining in popularity during recent years. However, such form may not be permitted in certain industries which are identified as "key" or "strategic" by Chinese government.

Still, WFOE is far from an ideal investment vehicle. For instance, it cannot set up subsidiaries and cannot issue shares to the public.

Due to the rigidity of JV and WFOE, other more flexible vehicles have begun to be used by some MNCs in China. These newer vehicles however are subject to government approval on a case by case basis.

Joint-stock Company

"Joint-stock company", also known as "company limited by shares", is another investment structure which is so far seldom used by MNCs. The only major examples so far of foreign-invested joint-stock companies are the two recently established by US film maker Kodak.

Joint-stock company is similar to western's limited-liability company except that the number of shares an investor holds defines his stake. It may issue shares either internally or publicly through the Shanghai or Shenzhen stock exchanges. Most listed companies in China are organized as joint-stock companies. Theoretically, MNCs can convert their JVs to joint-stock companies but cannot do so for their wholly owned subsidiaries.

Holding Company

In recent years, the Chinese government has allowed a new FDI structure - "foreign investment holding company" – through which a foreign group may own interests in a number of FIEs. The background of the creation of such structure was that after past two decades of open door policy, many foreign companies have set up dozens of operations in China and are facing the headache of how to rationalize and streamline their dozens of operations. Procter & Gamble for example, one of the most successful consumer-products companies in China, has thirteen JVs in six cities. German electronics giant Siemens has over forty JVs.

Holding company structure offers a convenient way for MNCs to group together multiple investments and allows integrated production, marketing and distribution to be conducted. However, this structure lacks many of the advantages of a true western holding company. First, intra-group lending is not allowed which means MNCs cannot use cash flows from existing operations to expand into new areas or use surplus cash flows from profitable operations to fund loss-making operations. Besides, such structure is tightly controlled and gaining approval from Chinese authorities is a lengthy process. In general, the Chinese government limits the use of holding company to substantial MNCs with a significant level of investments in China.

Group Finance Company

Even more recently, China has permitted the establishment of group finance company - "foreign investment enterprise group finance company" - by major MNC groups. Such structure increases the flexibility in financing MNC operations as it allows foreign investors to use excess dollar or Renmibi (RMB) from one FIE to fund the cash needs of affiliated FIEs (which have to be at least 25% owned).

Large MNCs such as Siemens, Volkswagen and General Motors are lately starting to establish financial companies to access the available funds of their own mainland operations. Siemens has taken the lead to establish Siemens Financial Services in late 1998. Other MNCs hope to be allowed to follow the Siemens example, yet this model can only be a solution for profit-making MNC operations in China.

CHAPTER III

FINANCING NEEDS OF MNCs IN CHINA

General Financing Environment In China

Given the differences between China and other countries in the way business activity generally is conducted and regulated, the environment of financing in China is different in some fundamental respects from those to which MNCs are accustomed.

First of all, all aspects of financing in China are highly regulated and subject to extensive government control. One reason is that many parties involved (such as domestic banks and the approving and regulating authorities) are government bodies. Raising foreign currency loans by both Chinese and foreign-invested enterprises has always been a time-involving process. This is because foreign exchange remains a tightly controlled commodity in China. SAFE[5] approval is needed for all foreign currency financing, which is often not given on commercial justification but more on prevailing government policy and benefits of the state.

Besides, the financing environment is fast changing and uncertain. This includes rapid changes in the related laws and regulations as well as the judicial

[5] State Administration of Foreign Exchange.

framework. In fact, it is not difficult to understand this during a period when China is undergoing drastic economic reform.

Furthermore, the structure of investment is inflexible as we just discussed. For example, JVs and WFOEs cannot establish subsidiaries and cannot use cash flows from affiliated operations without government approval.

Financing Concerns of MNCs In China

Given the highly regulated and rapidly evolving financing environment in China, MNCs generally have the following concerns in financing their operations in China:-

Political Risk

China is rated A3 by Moody's and BBB+ by Standard & Poors. The credit ratings reflect international rating agencies' confidence on China's economy and its foreign currency borrowing repayment ability. Despite the good credit ratings, China is still plagued by unexpected impositions of regulations, some of which are very difficult or costly for MNCs to comply with.

While remote at present, the risk of expropriation cannot be ruled out. MNCs operating in China do have this concern that their operations in China, even those wholly owned subsidiaries, may be nationalized or expropriated by the Chinese government under extreme circumstances.

Exchange Rate Risk

The impacts of exchange rate movement can be classified into three main types of foreign exchange exposure: transaction, operating and translation[6].

Transaction exposure occurs when financial obligations are incurred prior to a change in exchange rate but not due to be settled until after the change in exchange rate materializes. Operating exposure concerns more about the change in present value of a company as a result of the changes in future operating cash flows caused by the change in exchange rate. The impact of exchange rate change on future operating cash flow can exist in many forms including changes in selling prices and costs caused by a change in competitiveness. Translation exposure is the potential for accounting-derived changes in shareholders' equity to occur because of the need to translate foreign currency-denominated financial statements into a single reporting currency to prepare a consolidated financial statement. In view of the different kinds of foreign exchange exposure, MNCs all try to manage their currency exposure through hedging.

Foreign Exchange Control

In China, foreign exchange control is employed to protect their hard currency reserves. One of the main concerns of MNCs is the control on foreign currency payments to cover their imports. Such control can be very stringent when there is a

[6] Eiteman et al. 1998.

shortage of foreign currency resulted from an imbalance of trade, high level of external debt or pressure of currency devaluation. Interruptions to ordinary operations of MNCs can be severe under such circumstances.

China's foreign exchange authorities closely monitor the foreign exchange activity of MNCs through a range of reporting requirements. Under current regulations, to carry out basic current account foreign exchange transactions, MNCs must provide their banks with documentation that demonstrate their need of hard currency. Also, they need to obtain a foreign exchange registration certificate from SAFE that authorizes them to maintain hard currency account. Usually two hard currency accounts are maintained, one for current account and one for capital account transactions which is needed when foreign currency loans are raised.

General Financing Criteria Of MNCs In China

Maximizing Debt And Minimizing Equity

In China where political risk is perceived to be higher, MNCs generally tend to maximum debt and minimum shareholder equity. The advantages of such an approach include a higher rate of return or a shorter payback period, minimize losses in the event of expropriation.

Maturity Matching

While in structuring debt portfolio, maturity matching is very important. A MNC typically wants to finance current assets with current liabilities and long term assets with long term liabilities. This matching of maturity prevents the MNC from being exposed to significant interest rate and funding risks as different categories of asset turn over with time.

Currency Matching

Furthermore, to minimize exchange rate risk which is also perceived to be high in China, MNCs need to fund assets with liabilities of matching currency. As MNCs often possess domestic and foreign currency denominated assets, availability of both domestic and foreign currency funding is also very important to MNCs operating in China.

Financing Needs of MNCs in China

With due consideration of MNCs' general financing concerns and criteria, their financing needs are best fulfilled by a combination of the following:

Short-term Domestic Currency Financing

Almost all MNCs in China need short-term loans for working capital financing. They are necessary for payment of supplies and raw materials that can be sourced in China as well as payment of expenses such as salary.

Long-term Domestic Currency Financing

MNCs also need term financing, usually 5-7 years, for the purchase of land and construction of factory buildings in China. Such financing is also required for the purchase of equipment and machinery that are available from domestic suppliers.

Short-term Foreign Currency Financing

These are short-term trade financing and working capital loans for MNCs' import and export activities. For MNCs in export-oriented manufacturing business, trade financing facilities are particularly important. They are necessary for payment of imports and their subsequent repayment through exports.

Long-term Foreign Currency Financing

MNCs also require mid- to long-term foreign currency loans, usually 3-5 years, to finance the import of equipment and machinery, and advance technology which are available only through imports.

Hedging Instruments

In the light of the risks in foreign exchange and interest rate fluctuation, MNCs in general are in need of financial instruments to hedge their exposure in currency and interest rate risks. For instance, MNCs with substantial mismatch in currency will be in need of currency hedging in the form of forward or option contracts. While MNCs with substantial borrowings in RMB might wish to fix its borrowing costs by an interest rate swap to avoid an unexpected rise in RMB interest rate as a result of changes in economic policy of China.

CHAPTER IV

HOW MNCs IN CHINA CURRENTLY FINANCE THEIR OPERATIONS?

Availability Of Financing

A survey of 70 MNCs in China conducted in 1998 by The Economist Intelligence Unit and consulting firm AT Kearney found that 41% of the respondents' consolidated China operations were profitable, while 34% were unprofitable. The remainder broke even. Apparently, still a lot of MNCs' operations in China are not yet profitable. With an aim to minimize capital investments, MNCs have to seek external financing.

China's financial system is still largely banking-oriented: share of the banking system of financial intermediation is almost nine-tenths[7]. The markets for equity, bonds and other debt instruments in China are immature and institutionally underdeveloped. As such, almost all MNCs turn to the banking sector for financing. And as far as banking financing is concerned, under current regulation, FIEs are required to open their basic accounts with banks in their location of incorporation. Furthermore, bank financing are necessarily confined to banks in the vicinity[8]. This

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[7] Lardy 1998.

[8] The financial affairs of FIEs are required to be controlled and administered by the Department of Finance of the provinces or municipalities where the FIEs are incorporated.

means, a particular operation of a MNC is not allowed to borrow from banks located outside its places of operation, nor is it allowed to extend inter-company lending to group members which are located in other area of operation.

Domestic Banks

The banking system in China is almost entirely state-owned. And the state-owned banks are tightly regulated in terms of interest rates on loans, purpose and duration of loan as well as nature of borrowers.

The "big four" state commercial banks – the Bank of China (BoC), the Agricultural Bank of China (ABC), the China Construction Bank (CCB), and the Industrial and Commercial Bank of China (ICBC) - comprise the core of the banking system, together hold a market share in excess of 75 percent. Second-tier national commercial banks include the Bank of Communications (BoCom), China Everbright Bank, Hua Xia Bank, CITIC Industrial Bank and China Minsheng Bank[9]. Other domestic commercial banks with primarily regional focuses include the Shanghai Pudong Development Bank, Guangdong Development Bank and Shenzhen Development Bank. Table 3 shows some statistics about the major domestic banks.

Foreign Banks

Foreign banks in China currently occupy a peripheral role with a small market share of business activity. Yet these banks play an important role in bringing

[9] The first Chinese commercial bank with mostly private ownership.

necessary financing and services to MNCs in China. The number of foreign banks in China has reached 172 by the end of 1998, most of which are representative offices and branches. Hongkong and Shanghai Banking Corporation, Standard Chartered Bank and Bank of East Asia are among the three largest foreign banks in China. Table 4 lists some major foreign banks operating in China.

Foreign banks in China are only allowed to operate within strict guidelines. They are permitted to branch out to about 24 cities but each foreign bank is allowed to set up only one branch in these cities. Besides, foreign currency financing is what foreign banks are expected to concentrate on. Domestic currency financing was not allowed until about 3 years ago when a limited number of foreign bank branches were allowed to operate RMB business in Shanghai Pudong[10].

Foreign Currency Financing

Most MNCs' foreign currency financing needs are supplied by foreign banks operating in China, and to a lesser extent by the domestic commercial banks.

Foreign Currency Trade Financing

MNCs in China normally do not find it too difficult to be provided of short-term trade financing as long as their business is export-oriented and can prove to generate a steady flow of exports.

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[10] In 1997, Chinese authorities have allowed 19 foreign bank branches in Shanghai and 6 in Shenzhen to conduct RMB business.

Trade financing is usually made available by foreign banks. Nonetheless, foreign banks' role in this area is mainly restricted to opening or negotiating letters of credit[11]. Very often, foreign banks control their risk exposure by restricting the exports to be channeled through them so that the foreign currency payables of MNCs due to imports of raw materials and supplies can be properly settled through exports.

Trade financing can also be obtained from major domestic banks[12]. Normally sufficient security is required on top of careful control on export receivables that are required to repay foreign currency import financing provided to MNCs.

Foreign Currency Working Capital Financing

Working capital loan in foreign currency is much more difficult to justify if compared to trade financing. MNCs that need foreign currency working capital loans are mainly those which have to settle part of its payables in foreign currency but derive most of its revenue and hence receivables in RMB. Therefore, MNCs of this type need to rely on the conversion of RMB to foreign currency to repay their foreign currency working capital loans. Such a mismatch in currency is perceived to be of high risk and consequently this type of financing is not well received by foreign banks, not to mention domestic banks.

[11] Foreign banks with branches or representative offices in China can issue letters of credit.

[12] 15 designated domestic banks have the authority to issue letters of credit. The BoC however maintains a monopoly on this segment of business.

Foreign Currency Long-term Financing

Long-term foreign currency lending particularly tends to dry up for MNCs which are often expected to be capital providers rather than users. However, it can be provided by foreign banks but is only limited to MNCs where parent supports are given. Parent support can exist in many forms including parent guarantee, letter of comfort, majority shareholding and management undertaking, etc. MNCs are unlikely to be able to rely only on the strength of their local operations to obtain such financing from foreign banks as the perceived risks of long-term loan repayments in foreign currency based on the future cash flows and their convertibility to foreign currency remain high.

Foreign Currency Syndicated Financing

Syndicated loan as a form of hard currency financing is important for MNCs. However, availability is confined only to the biggest and most creditworthy MNCs such as General Motors. Foreign banks usually arrange such financing through their offices in Hong Kong or elsewhere. However since the start of the Asian financial crisis, such financing has become increasingly difficult to organize.

Domestic Currency Financing

RMB financing poses more of a problem to MNCs than foreign currency financing. RMB financing provided by foreign banks remain negligible. Usually MNCs turn to domestic banks for local currency borrowings. The four state commercial banks have a combined market share of over 90 percent of all local currency lending[13], though some MNCs also do business with the second-tier domestic commercial banks.

As a matter of fact, MNCs have the option of borrowing foreign currency and swapping it into RMB on the inter-bank market. This could eliminate the need to borrow from the domestic banks, if the initial foreign currency loan is obtained from a foreign bank. However, few MNCs find this option appealing, as it exposes them to exchange rate risk.

Domestic Currency Working Capital Financing

Working capital loans in RMB for the most part come from domestic banks. It is common for MNCs to obtain RMB financing from Chinese banks by providing security in foreign exchange. As Chinese banks will not accept a corporate guarantee directly from a foreign parent, the security must be either in the form of a guarantee issued by a foreign bank or a pledge of foreign exchange collateral.

A recent development is that for certain MNCs with large investments in China, some domestic banks are willing to lend against the guarantee of the holding company in China. Although the loan amount of such unsecured lending is usually small, this enhances the migration of the Chinese banks towards commercial banking of the western practice.

[13] According to China Statistical Yearbook 1997.

Domestic Currency Long-term Financing

It is very difficult for MNCs to raise long-term RMB loans. Recently however, the Chinese government has lifted the restriction for Chinese banks to finance fixed assets of a FIE in RMB for a term of up to five years. Therefore, RMB loans upto five years in maturity can now be obtained by MNCs in China through the support of stand-by letters of credit issued by their foreign bankers. This is particularly important for MNCs that plan to construct its own factories and equipment in China and is generating mainly RMB income in its future cash flow to service its debt.

Nonetheless, the fact that major funding source of Chinese banks comes from short-term deposits will hinder domestic banks' ability to lend on long-term. Besides, this relaxation of the rules may be illusory as many MNCs believe most five-year funds will be tied up in domestic infrastructure programs, such as the Three Gorges Dam.

Domestic Currency Syndicated Financing

Syndicated loan in domestic currency is uncommon as Chinese banks prefer to extend individual bi-lateral loans to their customers. Also another reason is that the syndicated loan market in RMB is very much underdeveloped without the involvement of foreign banks. Therefore, it is very difficult for MNCs to obtain long-term financing in the form of syndicated loan in RMB.

Hedging Instruments

In China, very limited foreign exchange hedging instruments are available to MNCs. Due to foreign exchange control, there is no foreign currency hedging market except currency exchange implemented at spot. Forward and option markets are non-existent with the exception of an offshore non-delivery forward market which enables the usual forward hedging without actual delivery of RMB[14].

Case Study

What have been discussed so far are general situations as regards MNCs' financing activities in China. The following case study is chosen to give a clearer picture of the situation. The name of the multinational company is not disclosed due to confidentiality issue.

Background Information

The parent of the Company is a European-based MNC operating hypermarkets worldwide. As of year-end 1998, the group operates more than 350 hypermarkets, about one-third in Europe and the remaining abroad[15].

In China, the Company currently operates more than 10 hypermarkets in 9 major cities. Most of the operations are in the form of JVs including those in Beijing,

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[14] Currently, only BoC is allowed to conduct forward contract.

[15] According to the Company's 1998 Annual Report.

Shanghai, Chongqing and Tianjing where the Company holds majority stake from 55%-60%. The remaining operations in Shenzhen, Dongguan, Shenyang and Wuhan are wholly owned subsidiaries. The Chinese government has recently decided to require all new hypermarket business to be controlled in majority by Chinese partner whereas foreign partner can only hold minority stake. In terms of future business expansion, the Company remains aggressive in China with a plan to open new shops every year. More cooperation with Chinese partners is expected to be the means to maintain growth in view of the new regulations.

The Company's operations in Shanghai, Beijing, Tianjing and Shenyang are doing fine. But those in Dongguan, Shenzhen and Chongqing are less satisfactory due to either location problems or insufficient income level of the locals.

Financing Requirements

Some of the Company's operations have already been building up sufficient cash surplus, however under the current regulation, surplus cash flow of one operation cannot be channeled to fund another operation. This couples with the need to fund the rapid business expansion, external borrowings are required. Alike other MNCs in China, the Company wishes to maximize the use of debt financing in local currency for hedging against foreign exchange risk. As such, external borrowing requirements are mainly in RMB.

The Company is now moving to centralize its financing activities with an aim to achieve more efficient financial management of its more than 10 JV and WFOE operations: -

- The use of one single group finance company to borrow RMB instead of borrowing through different operating subsidiaries;
- The use of a nationwide Chinese bank to centralize the daily cash flow of their operating subsidiaries in China.

How The Company Currently Finance Their Operations?

The Company's RMB needs are currently provided by a number of Chinese banks with the support of foreign banks. The RMB fundings are mainly in form of short-term working capital loans and they are provided by BoCom, ICBC, ABC and CCB. All the RMB borrowings are fully secured by stand-by letter of credit facilities from the Company's relationship banks, all of them from its home country in Europe.

As the financing activities have yet to be centralized, each JV and subsidiary still needs to establish its own banking facilities with the domestic bank branch in its location for the required RMB financing.

A Few Observations From The Case Study

- Under the holding company structure, intra-group lending is still not allowed though the holding company may negotiate loans on behalf of its subsidiaries/JVs and provide collateral and loan guarantees.
- MNCs such as this Company hope to use the group finance company structure to overcome the restraint of intra-group lending to increase the flexibility by allowing excess cash flow from one operation to fund the cash needs of another.
- MNCs still rely heavily on their home country relationship banks to support their operations in China;
- Standby letter of credit is a common security used by foreign banks to help their MNC clients to obtain RMB financing from domestic banks;
- Most domestic banks only lend against collateral;
- Domestic banks are reluctant to grant long-term financing using the same scheme.

CHAPTER V

RESTRIANTS OF THE FINANCIAL MARKETS IN MEETING MNCs' NEEDS

Lack Of Support From Domestic Banks

The big four state commercial banks were once known as "specialized banks" for their role as lenders to SOEs in specific sectors. After decades of policy lending, they are basically insolvent[16] today, burdened with the officially estimated RMB1 trillion non-performing loans of SOEs[17]. Though bank reform has freed the big four from further obligation to lend to loss-making SOEs, the progress towards making lending based on commercial criteria is slow. Meanwhile, the much smaller size of second-tier commercial banks makes them easier in implementing bank reform. Contrary to the big four, those second-tier banks cater almost exclusively to the private corporate sector including FIEs.

Yet as a whole, lending to FIEs (including MNCs) by domestic banks shared as little as 2.6% of total lendings of domestic banks as at end-1997[18].

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[16] Based on internationally recognized 8 percent capital-adequacy standard.

[17] According to information in Worldbank's web site: www.worldbank.org.

[18] According to The Economist Intelligence Unit.

Lack Of RMB Financing From Foreign Banks

First of all, for those foreign banks which are licensed only to make foreign currency loans, it is nearly impossible for MNCs to obtain RMB loans from them. Yet even for those limited few which are allowed to conduct RMB business, the capacity to do so is extremely limited. For instance, they are only allowed to receive RMB deposits from FIEs operated in the same places. As FIEs are more borrowers than depositors of RMB, it is impossible for foreign banks to attract sufficient RMB deposit for meaningful RMB business. This also explains why foreign currency loans are the primary business for foreign banks in China.

The situation has improved a bit recently when the Chinese government has relaxed its policies and allowed foreign banks to borrow long-term RMB funds from domestic banks on the inter-bank lending market. Citibank's Shanghai branch recently received a one-year inter-bank loan of RMB50 million from the BoCom. And the Shanghai branches of Bank of America, Credit Lyonnais, and the Industrial Bank of Japan obtained a 3-5 year loan of RMB160 million from the Shanghai Pudong Development Bank. This enable foreign banks to get necessary fundings to support MNCs in China.

The recent policy relaxation of allowing domestic banks to accept foreign bank guarantees or stand-by letters of credit payable in foreign currency as collateral to extend RMB financing to FIEs have also helped alleviating the financial problems of MNCs in China.

Lack Of Long Term Financing

The long adopted policy of China towards FIEs financing is to ensure that FIEs would come up with the necessary foreign currency to finance all fixed assets requirements. This is in line with China's policy to attract FDI for economic development. Accordingly, it is not the intention of domestic banks, which are almost all state-owned and -controlled, to provide long-term foreign currency financing to MNCs operating in China.

However, raising mid- to long-term RMB financing from domestic banks is also difficult. This is because most domestic banks do not possess adequate credit assessment skills and are therefore reluctant to extend long-term loan on commercial basis (policy loans to SOEs do not require credit assessment skills). Moreover, the poorly developed long term funding markets for the banks themselves prohibit the banks to lend long-term. Domestic banks are more willing to provide both short-term foreign currency import and export financing and short-term RMB working capital financing to MNCs.

Lack Of Access To Equity Financing

For capital financing, weak financial institutions and underdeveloped financial markets are the major causes for the lack of such long-term financing. Despite the fact that China has begun trading securities with the opening of the Shanghai securities exchange in 1990 and the Shenzhen exchange in 1991[19], the equity market is still small in relation to the economy and in general lack liquidity.

As a matter of fact, most MNCs' operations are structured as JVs or WFOEs which cannot issue shares under the current legislation. Though JVs may be converted to joint-stock companies with approval of MOFTEC and issue shares on the stock exchanges, only a few MNCs operating in China have taken advantage of this mechanism. This is because access to China's equity markets are tightly controlled by the central authorities and the quota system they used heavily favored SOEs in key industries. It is also true that investment banking services, such as underwriting and placement of shares, are not at all available in China to assist MNCs in obtaining equity financing from the domestic market.

Lack Of Bond Market

Bond market remains the least developed segment of China's capital markets. Apart from state treasury bonds and some SOEs engaged in infrastructural projects, corporate debt issuance is extremely limited. The industry lacks a clear legal framework. Besides, Chinese government worries that the investors are lacking the necessary knowledge and maturity and might become victims of poor quality bonds which are allowed to be issued. Though the need of MNCs to issue bond in the

[19] One feature of the stock exchanges in China is that they trades two classes of shares. Class A shares are available only to Chinese nationals, where quotes and clearances are in RMB. Class B shares are quoted in Hong Kong dollars and are available only to foreign shareholders.

Chinese domestic market at the moment is not big, with the increase in scale and importance of MNCs in China, such need will be growing fast.

Lack Of Hedging Instruments

There is no or limited availability of such services at the moment and such needs of MNCs remain a vacuum to be fulfilled.

CHAPTER VI

ANTICIPATED FUTURE CHANGES OF THE FINANCIAL MARKETS IN MEETING MNCs' NEEDS

Impacts Of WTO[20]

WTO membership is not only important for China to gain freer access to the world's export markets, but also a milestone development in China's economic reform towards a modern and market-oriented economy. The impacts of WTO entry on the financial markets are large and broadly based.

Impact On Banking Sector

On the banking sector, China will likely continue to open the door further to foreign banks to meet WTO requirements. Most Chinese officials have come to realize that a more competitive banking environment will improve both services in the industry and bank profitability. They also value the opportunity to learn from foreign banks.

One most noticeable change anticipated is the removal of restriction for foreign banks to access to the Chinese market including the freedom to deal in RMB.

[20] World Trade Organization.

Of course, there is likely to be a time frame for such change. This implies that the domestic banks will be left with no alternative but to reform to be able to face increasing foreign competitions. Competition will be the best means to achieve improvements in products and services of Chinese commercial banks. Such anticipated changes for both foreign and domestic banks are going to benefit many MNCs in China.

Impact On Equity Markets

In joining the WTO, China would also promise to bring much-needed liberalization and growth to the stock markets. This will impact the development and liquidity of the financial system and hence provide an alternative funding source for MNCs. MNCs can substitute debt for equity and relieve the pressure of relying too heavily on the banking sector in financing their operations.

Impacts of Banking Reform

Impact On Domestic Banks

Resulting from decades of policy lending and generally poor lending policies, domestic banks' balance sheets are burdened by non-performing loans. China has learnt a great deal, however, from the Asian financial turmoil, and has in recent months begun deepening reform measures which have become more urgent as negotiations for China's entry into the WTO have gained momentum. To bring its banks up to the international banking standard for adequate equity of 8 percent of total assets, the Chinese government has injected RMB270 billion - financed by Treasury-bond issues - into the state banks in 1998. Besides, four asset management corporations have been set up to take over and manage the non-performing loans of SOEs, each paired with one of the big four banks: Cinda (CCB), Great Wall (ABC), Oriental (BOC), and Huarong (ICBC). Other reform deepening measures include improving banks' management quality and control systems at all levels, and introducing modern risk evaluation methods and professional credit analysis. In short, the banks are required to move towards lending based on commercial decisions rather than government policies.

As far as lending is concerned, today still most domestic banks are not accustomed to balance sheet lending and hence they usually lend to FIEs including MNCs against collateral, often asked for in cash. It is anticipated that Chinese banks will continue to increase flexibility in their lendings. Currently, banks can issue foreign currency loan against a stand-by letter of credit or a guarantee issued by a foreign bank. Even most recently, a guarantee from a local holding company of the MNC is accepted though only in a few occasions. Such change will significantly widen MNCs' financing choices.

Besides, with domestic banks now adopting commercial-oriented policy towards lendings, they are paying more attention to quality customers in particular MNCs. For instance, CCB revealed that they had started to offer preferential policies to MNCs in China, such as Shanghai Bell, General Motors, Siemens and Shanghai Johnson, to ease their financing burdens. Though to obtain such preferential treatments, MNCs still need to meet a lot of requirements: investing in the businesses sectors encouraged by the government; having a long-term plan of management and a strong development potential; supporting sustainable businesses and operating with strict standards and high credit[21]. Actually, expanding financing to MNCs is a basis for Chinese banks to broaden their lending portfolios, teach themselves risk assessment and thus build up the relationships required to compete with foreign banks on a more level playing field after China joins the WTO. As the state commercial banks discover the viable lending opportunities presented by MNCs, MNCs' access to local currency loans from local banks should increase.

Impact On Equity & Bond Markets

Another important impact of the financial restructuring of the banking sector and the SOEs is Chinese government's plan for a massive debt-equity swap. The swap is intended to reduce the leverage of SOEs, provided them with additional funds for investment in technological upgrading, and pave the way for stock market listing. The debt-equity swap program should, over the next few years, lead to a huge expansion of China's equity market and overseas listings.

This will accelerate the development of the equity and bond markets in China. First, the equity market has to grow relative to the bank credit market, if only to address the fundamental shortage of capital funds for the SOEs. Second, developing the bond market has the basic objectives to fund the budget deficit and to provide an instrument to fund long-term investments, particularly in the infrastructure and

[21] "CCB to strengthen cooperation with multinational corporations." People's Daily, 8 November 1999.

housing areas. Such developments will be beneficial to MNCs in China by making available other sources of financing especially the longer-term financing.

CHAPTER VII

RECOMMENDATIONS TO MNCS IN CHINA AS REGARDS FINANCING

Explore Other Entry Modes When Setting Up Operations In China

Evidence shows that more and more MNCs no longer stick to the old form of JV and WFOE in setting up their operations in China. Newer entry modes provide more flexibility as far as financing is concerned. For instance, joint-stock company provides opportunity to raise equity financing in the domestic market, holding company structure allows MNCs to integrate multiples of operations under one roof for easier management, and group finance company allows more flexible cash flow and financing management. MNCs are advised to explore and consider all available alternatives of market entry modes when entering China or expanding their operations in China which will have significant impact upon financing available to them.

Centralize Finance Activities For Efficient Management

Previously, all MNCs' operations in China are required to open their basic accounts with banks in their location of incorporation. Furthermore, bank financing is necessarily confined to banks in the vicinity. Because of these regulations, MNCs are not allowed to borrow from banks located outside their places of control, nor are they allowed to extend inter-company lending to group members which are located in another area of control.

Given that such a system is too restrictive from efficient financial management point of view, it has been relaxed somewhat recently. Taking this advantage, MNCs should apply to local authorities to centralize their various operations' finance activities under an umbrella to achieve efficient financial management, for example by setting up a group finance company like what the Company in our case study is attempting to do now. By doing so, a profitable member of a group can use its surplus cash flow to support a loss-making or start-up member. Also, the MNC can use a single vehicle to borrow and thereby allocate the funding raised to various operations according to their needs. This avoids the troublesome procedures that each operation negotiate and obtain its own financing from bank branch located in its area.

Cultivate Relationship With Domestic Bank

Currently, only a few MNCs maintain real relationship with domestic banks. On one hand, the state commercial banks do not possess much knowledge about MNCs and have no idea how to assess their credit risk. On the other hand, MNCs may find it difficult to deal with domestic banks due to the poor service quality. As a matter of fact, domestic banks are usually a source of frustration for many MNCs. Most often, MNCs' relationship with domestic banks was built up through foreign banks when the latter arrange the stand-by letter of credit -secured RMB financing for them.

With domestic banks now paying their attention to quality customers and the emergence of second-tier commercial banks which are more business-oriented, it is time for MNCs to establish real relationship with at least one domestic bank. This will not only diversify MNCs' financing source, but also help many MNCs obtaining necessary RMB financing.

Maintain Good Relationship With Foreign Banks

Our study of MNCs in China shows that still most MNCs are relying on foreign banks for necessary financing. This include not only foreign currency financing but also RMB financing. A significant portion of MNCs' RMB financing needs are provided by domestic banks through the support of foreign banks' stand-by letters of credit. Such financing is usually initiated and arranged by foreign banks, many of which actually follow their MNC clients to China and have clear understanding of their clients' financing needs.

Despite the recommendation to establish relationship with domestic bank, it is also important for MNCs to maintain good relationship with their foreign bankers which are, and will continue to be, playing important role in financing their operations in China. This is especially true after China's entry into the WTO which will open up China's financial markets and widen the scope of business activities allowed to be conducted by foreign banks. MNCs should stand to benefit from such change.

Improve Financial Accounting And Reporting Of China's Operations

Although currently almost all financing to MNCs are fully-secured, MNCs operating in China should still pay attention to their financial and accounting reporting. At present, such information reported are limited to those required by the Chinese government and there is no detailed requirement. In the absence of sufficient disclosure and reliable financial statements, it is difficult for MNCs to obtain support from domestic banks if the banks really started to lend based on credit worthiness and commercial conditions. As a matter of fact, a number of banks have already started to lend based purely on the strength of MNCs' local operations through the local holding company's guarantee. Improvement in financial reporting will also help MNCs to get access to other sources of financing once they become available.

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